

## **TESTIMONY OF N.G. BROOKES**

**Before the Senate Commerce Committee  
February 24, 1998**

My name is Nick Brookes. I am chairman and chief executive officer of Brown & Williamson Tobacco Corporation.

B&W is one of the five tobacco companies that negotiated the June 20, 1997 Proposed Resolution, along with State Attorneys General, representatives of the public health community, and counsel for plaintiffs in litigation against the industry. This agreement reflects a remarkable consensus on issues that seemed impossible to resolve in the past. I am pleased to provide the Committee with my comments in support of this resolution.

The Proposed Resolution represents a chance to end the stalemate that has characterized tobacco policy for more than a generation. It would replace confrontation with cooperation and would produce a total reformation of the way tobacco products are manufactured and marketed in the United States.

Since the Proposed Resolution was announced, this unique opportunity for change has frequently been overshadowed by suggestions that the industry be punished more, that additional costs be imposed and that any benefit the industry might receive be stripped away. We respectfully urge this Committee and the Congress to focus on what will benefit the American public, not what will punish tobacco companies.



The Proposed Resolution contains virtually every youth smoking and health initiative sought by the public health community. It would also settle certain types of claims trading the arbitrariness and inefficiency of an unlimited tort system for an assured stream of payments to fund the costs of treating tobacco-related diseases and research, and cessation programs. The focus of the debate concerning the Proposed Resolution should be whether this agreement is a good one for the American public. Today I would like to highlight the very real progress the June 20 agreement represents, explain the very real costs — financial and otherwise — that this proposal would impose on the tobacco industry, and speak plainly about what the industry would receive in return.

### **The Proposed Resolution Represents an Opportunity to Achieve Public Health Goals**

Our commitment to a new cooperative approach can be seen in the way the Proposed Resolution attacks underage tobacco use on all fronts. In fact, the proposal incorporates virtually every suggestion ever made by critics of the industry, including:

- banning all outdoor advertising and all use of human images or cartoon characters, in addition to other drastic advertising and marketing restrictions;

- imposing additional strict controls on the sale of tobacco products to prevent young people from getting them;

- providing funding for massive public health campaigns to discourage youth smoking; and

- requiring huge additional payments if dramatic reductions in underage tobacco use are not made.

In fact, the Proposed Resolution incorporates all of the advertising and marketing restrictions proposed by the FDA, despite the fact that the courts rejected these restrictions because they exceeded the FDA's statutory authority. It also includes additional restrictions not in the proposed FDA regulations. Most of these restrictions would violate our First Amendment



rights and could, therefore, be imposed only with the agreement of the industry. These restrictions — such as eliminating outdoor advertising and human and cartoon characters — are among those that are most desired by public health advocates.

The Proposed Resolution also sharply limits young people's access to tobacco products. It would incorporate *every* access restriction in the FDA rule, without preventing State or local governments from imposing stricter limits. The Proposed Resolution also adds significant restrictions to the FDA rule, including banning vending machine sales and self-service displays.

Additionally, the Proposed Resolution would impose huge surcharges on the industry if aggressive national goals for reducing youth smoking are not met. The industry agreed to these surcharges despite the fact that the Proposed Resolution already requires the industry to take virtually every step its critics have identified to reduce youth smoking. And we agreed to them despite the fact that common sense — and an increasing body of research — indicate that a minor's decision to smoke is driven by peer group pressure, parental influence, and other factors that are completely outside the control of the tobacco companies. Nonetheless, these surcharges will give the industry a powerful economic incentive to find innovative means to try to reduce underage tobacco use.

The Proposed Resolution also addresses much more than youth smoking. It would, for example:

- provide the FDA with comprehensive authority over tobacco products;
- add dramatic new warnings on tobacco product packages;
- mandate sweeping changes in the way we do business; and
- impose nationwide restrictions on indoor smoking.

In addition, the tobacco industry has agreed to make massive payments — up to \$368.5 billion



over the next 25 years — to settle some of the claims against us and to fund a variety of public health initiatives. Payments of this magnitude have never before been imposed on any industry.

### **Burdens Imposed by the Settlement**

Some opponents of the Proposed Resolution have characterized it as a “sweetheart deal” for the tobacco industry. It is anything but that. We negotiated this agreement with some of the industry’s strongest opponents. They forced the industry to accept restrictions that will be extremely difficult to bear. In agreeing to the Proposed Resolution, B&W has accepted obligations that burden our company far more than you may realize.

Legislation based on the proposed resolution would transform the industry. The massive price increases, increased antismoking programs, marketing restrictions, and indoor smoking restrictions will lead to large volume declines. We have retained economist Robert Crandall of the Brookings Institution to conduct an econometric analysis of the effects of the Proposed Resolution on the cigarette industry. During the past six months, he and a team of economists have conducted an exhaustive analysis. I will rely on this work in this statement, and we invite this Committee to hear his conclusions first-hand.

Among other things, Dr. Crandall’s analysis predicts that the proposed settlement would increase the price of cigarettes by nearly 50% in real terms over the next five years. This price increase alone would be expected to decrease overall cigarette volume by 33%. Dr. Crandall estimates that the Proposed Resolution would cut industry profits by more than half in five years. The non-economic restrictions in the Proposed Resolution would only add to these adverse effects.

Cigarette marketing would also be changed greatly. There would, of course, be much less cigarette advertising. Declines in volume and increased inventory costs would accelerate



consolidation at the wholesale level, reducing the number of distributors available to us. Cigarette retailing will be much different, with limited point-of-sale communications permitted and cigarettes displayed only in the limited space behind the counter.

This will be a much tougher market in which to sell cigarettes — one that will be particularly tough on Brown & Williamson. B&W is the third largest of the “big four” cigarette manufacturers. We currently have a 16% share of the cigarettes sold in the U.S. However, because we have a relatively higher proportion of lower-priced, lower-profit-margin “value for money” products, our share of industry revenue and profits is smaller than our share of industry volume. For example, the largest cigarette manufacturer has three times our domestic market share but six times our domestic operating income.

As a result, the adverse financial costs of the proposed resolution will hit B&W especially hard. To illustrate:

Brown & Williamson’s \$1.7 billion share of the initial \$10 billion payment alone is more than twice our 1996 annual domestic operating income.

The average annual payment by B&W over the next 25 years is more than three times the highest annual operating income we have ever achieved.

- Put another way, this average annual payment is more than 75% of our total net sales revenue last year.

These numbers do not include the extensive compliance costs B&W would incur as a result of the Proposed Resolution: redoing packaging to include new labeling requirements, preparing new reports, complying with new regulations.

We expect that these payments will put B&W at a competitive disadvantage. Because the annual payments are allocated on a per-unit basis — rather than a revenue or profit basis — they will eat up a relatively higher percentage of B&W’s profits than those of our competitors.

It is no answer to argue that B&W should be unaffected by the settlement because we



can pass costs on to our customers. In fact, the requirement that we pass on these settlement costs will only lead to a decline in our sales volume. Since sales of our “value for money” brands depend heavily on price, increases in price are likely to hurt B&W by reducing the relative price gap between our products and those of our competitors. As declining sales are spread over our fixed costs, our profits must fall.

Beyond the plain financial burden of the settlement, the Proposed Resolution would burden Brown & Williamson by radically restricting our ability to sell our product to adults. We don’t have the best-known or the most widely sold products. In order to survive, we need an opportunity to explain to smokers that our products are better than our competitors’ products. The advertising and marketing restrictions in the Proposed Resolution make it difficult for us to do that. Historically, advertising and marketing restrictions tend to entrench established, well-known brands. The most popular brands will benefit; B&W’s less well-known brands are likely to suffer.

Consider B&W’s value-for-money brands. These products depend on pricing for their competitive advantage. Restrictions on advertising, particularly at point of sale, and elimination of self-service displays will help premium brands at the expense of value-for-money brands by making it more difficult to communicate those price advantages to the customer. Meanwhile, the Proposed Resolution’s advertising and marketing restrictions are likely to channel competitive activity into the price arena. Since “Marlboro Friday” in 1993, discounting of premium brands has been an important strategy for our competitors. If the Proposed Resolution is enacted, manufacturers of premium brands will use money formerly spent on advertising to engage in even more aggressive price competition, taking away our price advantage. Even without discounting of premium brands, the across-the-board price increase caused by the ongoing payments will



diminish the relative price differential between premium and discount brands. If a discount brand is \$1.60 per pack and a premium brand is \$2.00 per pack, the discount brand has roughly a 20% price advantage. If prices for all cigarettes go up \$1.50 per pack, the price advantage between a \$3.10 discount brand and a \$3.50 premium brand goes down to about 11%. This decline in relative price advantage can only hurt our discount brands.

We have only reluctantly agreed to these costs and these restrictions as part of a comprehensive, cooperative solution to tobacco issues. We recognize that such a solution can be achieved only if all parties are willing to compromise.

### **Prohibition through Taxation**

Regrettably, some critics of the Proposed Resolution are unwilling to accept any compromise. They claim that even more severe restrictions should be imposed on the industry. Their proposals seem to place a higher priority on attacking the industry than on achieving the health goals they purport to value.

Proposals that would dramatically increase tobacco taxes, like that recently introduced by Senator Conrad, are examples of efforts that would fail to achieve the health goals sought because of their focus on punishing the industry. Although we have many disagreements with the Conrad bill, I will focus here on its economic aspects.

S. 1638 would require the industry to pay the government \$15 billion within 90 days of enactment. It is difficult to characterize this as anything other than outright government confiscation. The bill does not specify how this payment will ultimately be divided, but I assume that B&W's share is likely to be around \$2.5 billion. Of course, since S. 1638 makes this payment non-deductible, the effective cost would be vastly greater. B&W does not have this kind of money. B&W's share of this payment alone would take from us an amount roughly equal to the



company's domestic operating income for the past four years.

S. 1638 would also impose "annual assessments" on cigarettes of \$1.50 per pack by 2001. This would effectively result in an increase in the excise tax on cigarettes by almost 700% in three years — from today's 24¢ excise tax to \$1.89, including the 15¢ federal excise tax increase already scheduled to take effect.

These astronomical price increases are claimed to be needed to discourage youth smoking. But it is not clear that underage smokers are more sensitive to price than adults. Recent experience in Canada, where youth smoking increased despite sharp increases in cigarette taxes and an advertising ban, suggests that young people are not particularly sensitive to price. But even if it were clear that underage smokers were more price sensitive than adults, it is even more clear that adults buy more than 96 percent of all cigarettes. The burden of these price increases will fall squarely on the adult smoker — the regular smoker who smokes daily rather than the teenager who might experiment with an occasional cigarette. Increasing the price of cigarettes by \$1.50 to lower youth smoking makes no more sense than raising the price of gasoline by \$1.50 to discourage youth driving. ma

Moreover, this tax is among the most regressive tax increases ever proposed. S. 1638 would increase the federal taxes paid by a two-pack per day smoker by \$1100 per year. And this tax will be paid, in the main, by ordinary working class citizens: the average smoker of B&W's products has an income of \$22,500 per year. The burden of this increase in the cigarette tax on U.S. households in the lowest fifth of income distribution would be 3.6 times as great as for the average household and 8 times as great as the burden on households in the highest fifth of income distribution.

These sharp tax increases would be devastating for the tobacco industry, farmers and



others who rely on tobacco for their livelihoods. Dr. Crandall's economic analysis shows that S. 1638 would increase the average price of a pack of cigarettes by 79% and reduce consumption by 61% in five years. It would create a massive industry loss of \$9 billion dollars over the 10 year period 1998-2007, which is likely to bankrupt several tobacco companies.

On top of these other burdens, S. 1638 would impose confiscatory "lookback" penalties if youth smoking reduction targets are not met. These targets seem to be designed to be unattainable. The bill calls for a baseline survey to be performed in 1999 — *after* the huge price increases needed to finance the \$15 billion upfront payment, *after* the first 50¢ tax increase, and *after* the advertising and marketing restrictions in the act would have gone into effect. In other words, S. 1638 puts into effect all of the measures intended to reduce smoking and measures youth smoking for purposes of setting a benchmark only after they have had a chance to work. It then imposes huge penalties on manufacturers if youth smoking is not reduced even further. Since even the government's own studies show that the main determinants of youth smoking — peer pressure and parental influence — are outside the control of the manufacturers, it is difficult to see how the tobacco industry could achieve additional reductions on top of all the measures the health authorities have advocated for so long.

If these rigged lookback targets are not met, S. 1638 would impose a 10¢ per pack penalty on all members of the industry, regardless of actual youth use of any particular manufacturer's products. For example, Brown & Williamson's products are used by fewer young people than those of any other major cigarette manufacturer. Surveys conducted for the U.S. Centers for Disease Control (TAPS and TAPS-II) report measurable smoking by people 12-18 years of age of only one of B&W's cigarette brands, KOOL, which was reportedly smoked by only about 1% of the respondents. As a result, B&W believes that all of its cigarette brands



together are probably used by only about two percent of young people. By contrast, B&W's share of the total cigarette market is roughly 16%. As a result, S. 1638 would require B&W to pay this industry-wide penalty despite its small share of the youth market and despite the fact that B&W would have little or no control over whether this industry-wide target is met.

S. 1638 also imposes an additional penalty of up to 40¢ per pack if an individual manufacturer's products do not meet the lookback targets. Here, too, the bill has the perverse effect of disadvantaging B&W precisely because of B&W's current excellent record on youth tobacco use. Since the bill requires each manufacturer to reduce the number of young people using its brands by the same percentage, a manufacturer such as B&W starting from an already low base would have more difficulty obtaining further reductions than a manufacturer whose products are used by a large number of young people. If a manufacturer has any control over youth smoking, it should be easier to go from 40% of the youth market to 30% than from 2% to 1.5%. But if B&W does not meet the target, it would be subject to the same penalty as a manufacturer who had the same percentage reduction but a 40% share of the youth market.

The cumulative effect of these oppressive payments and penalties is clear. The tobacco industry would turn over its money to the government until it was forced out of business. No industry can afford such payments. No industry can generate that much money. Putting these payments in perspective, stock analyst Gary Black recently pointed out that, if the Conrad bill were adopted, "in year 11, assuming the industry misses its lookback targets, the industry could be paying \$40 billion per year in payments and penalties — compared to 1997 total industry profits of \$8.5 billion."

It should be clear that these massive government levies on the tobacco industry have another, unadvertised purpose. The administration's proposed budget gives the game away: the



youth smoking controversy is being used to generate money to fund new entitlement programs. This may explain why many attacks on the Proposed Resolution have focused on adding more money. The Proposed Resolution already contains all the tools recommended by the public health community to attack youth smoking. Extracting more money from the tobacco industry bears only the most tenuous relationship to youth smoking. But it will provide cover for new rounds of government largesse.

Unfortunately, the payments imposed by S. 1638 pose a serious risk of destroying Brown & Williamson and, indeed, an entire industry that generates some 1.8 million jobs and more than \$50 billion per year in wages and other compensation; raises tax revenues of more than \$35 billion per year; and represents almost 3% of the total value of all farm commodities. More directly, this could render worthless billions of dollars that Americans have invested, either directly or through mutual funds and pension plans, in the stock of companies manufacturing and selling a legal product.

Some critics of the tobacco industry may applaud the bankruptcy of a tobacco company, or of the entire industry. But that would realistically serve no purpose. The bankruptcy of a tobacco manufacturer would hurt our employees, our suppliers and the communities we serve; it would not end the sale of cigarettes. It may be that new companies, or our foreign competitors, would step in to take our place. But it is certain that the black market would do so. Keep in mind that none of the regulations in the Proposed Resolution would apply to these black market cigarettes. Their sellers would not be licensed, and it is unlikely that these sellers would care to verify the age of purchasers. This is no way to stop youth smoking.

We cannot agree to legislation that would put us out of business. This is the reason that we must oppose higher payments or more restrictions. This is also the reason we cannot agree to



any legislation that does not include the limited, common sense civil liability protections in the Proposed Resolution. We cannot agree to give up our Constitutional rights to market our products to adults and consent to crushing annual payments and lookback penalties, without receiving some certainty as to the future of our business.

### **Civil Liability Provisions of the Proposed Resolution**

In return for the sweeping changes that meet the demands of the public health community and for payment of massive sums of money, our primary benefit is a limited amount of financial stability from the resolution of some product liability claims against the industry. The most significant of these are claims by States and other third-party payors for medical costs and claims by a variety of plaintiffs for punitive damages. The Proposed Resolution achieves this settlement by placing limitations on product liability claims against the industry — while preserving the rights of individual smokers to bring suits against the industry, as well as punitive damage claims as to any future industry conduct.

Some opponents of the Proposed Resolution have characterized these restrictions as “immunity” for the industry. But as Attorney General Grant Woods of Arizona told the Senate Judiciary Committee, “There is no immunity.” (Testimony of July 29, 1997.) In fact, our companies have been criticized for agreeing to settle for far less than immunity. Professor Tribe of the Harvard Law School — a longtime critic of the tobacco industry — explained to the Senate Judiciary Committee that “the proposed legislation does not abolish private State-law claims against tobacco companies”:

It does not even cap such claims, although — depending on the volume and size of judgments — it may have the effect of postponing the ultimate payment of some of those claims and discounting their magnitude by not providing for payment of interest. . . . The global settlement thus ensures that all those injured by tobacco



will have the opportunity to have their day in court to seek appropriate compensation. (Emphasis in original.)

(Testimony of July 29, 1997.)

Although the civil liability limitations in the Proposed Resolution do not end civil litigation, they are valuable because they provide some stability to our business. We defended product liability cases for more than 40 years before entering into the current settlement. But we also recognize that the court system can be unpredictable. The civil liability provisions of the Proposed Resolution help us by giving us some certainty as to our future litigation costs.

But it is not just the tobacco industry that will benefit from these civil liability limitations. As Attorney General Gale Norton of Colorado told the Senate Judiciary Committee on July 16 of last year, there are three possible outcomes if huge damage suits against the industry continue. First, the tobacco companies may well win all the cases. Second, the industry could lose. This could result in the bankruptcy of the current cigarette manufacturers, preventing anyone but a few lucky plaintiffs from recovering anything at all from the companies. Finally, the litigation could have mixed results, with tremendous amounts of time and money spent on litigation that resulted in some plaintiffs recovering huge amounts while others got nothing. I agree with Attorney General Norton that, from a public policy perspective, a settlement is preferable to each of these alternatives.

Moreover, endless civil litigation is not the way to resolve questions of basic social policy. Much as I respect the jury system as a way to resolve litigation, I do not think that juries should be asked to resolve broad social issues, such as the circumstances under which cigarettes should be sold. Matters of legislative policy should be resolved by Congress, not by courts. And we should not put the livelihoods of hundreds of thousands of people who work in the tobacco industry at the mercy of unpredictable and inconsistent jury decisions.



By limiting the risk of crippling liability awards against the industry, these civil liability provisions ensure our ability to make the billions of dollars of payments called for by the Proposed Resolution: payments which will provide funds for medical expenses, fund billions of dollars of cancer and other research, pay for smoking cessation and anti-smoking programs, fund public health and other initiatives, and provide up to \$5 billion per year in damages in suits brought by smokers and other individuals.

### **A New Era for the Tobacco Industry**

Our critics are quite vocal in their charges that we must receive nothing from this settlement proposal. Missing from their calls has been any meaningful discussion of youth smoking or the public health benefits of the Proposed Resolution. The Proposed Resolution's critics have not identified a single youth access, marketing restriction, or other initiative to reduce youth smoking that is not already included in the Proposed Resolution. The reason is clear. The Proposed Resolution contains everything the President and then-FDA Commissioner Kessler sought when they commenced the current youth smoking debate three years ago, and much more. In fact, the Proposed Resolution contains virtually everything on the public health community's wish list — a long list of concessions that “would have been unimaginable only months ago.” (Testimony before the Senate Judiciary Committee, June 26, 1997.)

These historic compromises were made possible only by the tobacco industry's change of position from one of confrontation to cooperation and the industry's agreement to an array of changes, including advertising and marketing restrictions that, absent the industry's agreement, would not pass muster under the Constitution. These same restrictions — including a ban on human and cartoon images, a ban on all vending machine sales, and a ban on all billboards and other outdoor advertising — are the very steps that many public health advocates believe will be



among the most effective in reducing youth smoking.

The irony is that by choosing this course of cooperation and compromise, the tobacco industry has, at least in the short term, only opened itself up to more attacks. And it is ironic that B&W has voluntarily agreed to the burdens imposed by the Proposed Resolution even though the available evidence suggests that our brands account for only about 2% of underage sales.

Tobacco manufacturers were once regarded as valued corporate citizens. Even up to the late 1970s, the industry and the government made real efforts to cooperate on health issues. At some point, relationships changed from cooperation to conflict. This may have been an understandable response to the litigation directed at our industry. But I suspect that we probably would not need to be here today if our industry had done more to cooperate with public health authorities in the past.

Looking back, I believe that the industry — and B&W — was too confrontational. We should have tried harder to cooperate with the government and public health groups to solve problems rather than argue about them. I acknowledge that Brown & Williamson contributed to this adversarial environment.

We cannot change past events, much as we might like to do so. We need to move forward. I believe that the Proposed Resolution represents the best opportunity in decades to achieve real progress on a host of tobacco issues. We all agree that these issues are of urgent national importance. I respectfully submit that they can be resolved only by comprehensive, balanced legislation on the national level. And I submit that they can best be resolved with the cooperative agreement of the various interested parties.

As the tobacco industry has held out its hand in cooperation, however, some of our opponents have used this as an excuse to step up their attacks on our industry. We hear demands



for more money and more punishment for the industry. These attacks threaten to undermine our chance to achieve the goals we have in common. More than that, they threaten to make the situation worse. The youth of this country will not benefit from legislation that generates years of constitutional challenges instead of immediate action. They will be hurt, not helped, if family members lose jobs and savings as a result of tobacco company bankruptcies. And they will be hurt if legislation results in unregulated, unlabeled contraband cigarettes for sale on the street corner. I urge you not to let attacks on the industry destroy this opportunity for progress. It is hard enough to avoid repeating past mistakes. Let us not make new ones.

### **Conclusion**

We ask you to judge us not by looking at the past, but rather by looking at what we have committed to do in the future. We do not ask you to rely on our word that we will accomplish these revolutionary changes. As part of the Proposed Resolution, we have agreed to a comprehensive system of oversight and regulation by the FDA and other federal agencies that will make our industry one of the most regulated in the entire American economy.

I recognize that it will be a long, hard road for my company and my industry to regain the public credibility and respectability that it has lost. We are committed to stay the course. We ask that you not allow those who would further politicize this issue and demonize our companies to destroy this opportunity.

Finally, I realize that this process involves many complex and controversial issues. In our negotiations, we have tried to anticipate as best we can those issues and to find solutions. However, these efforts were not an attempt to subvert the process of Federal lawmaking. We at Brown & Williamson have no expectation that Congress will merely rubber-stamp the agreement of June 20, 1997. We respect the authority of Congress in this matter, and we stand ready to



provide whatever assistance we can to address the issues you may wish to raise with us.